

Spring 1-1-2008

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### Recommended Citation

Kevin Leo, *Defining Substantial Activity: Helping Tax-Exempt Hospitals Keep Their Tax-Exempt Status*, 4 Hastings Bus. L.J. 297 (2008).  
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# DEFINING SUBSTANTIAL ACTIVITY: HELPING TAX-EXEMPT HOSPITALS KEEP THEIR TAX-EXEMPT STATUS

Kevin Leo\*

## I. INTRODUCTION

A joint venture is a partnership between or among two or more parties whereby each party contributes a portion of its assets, expertise, or activities for the purpose of performing a specific business transaction.<sup>1</sup> Joint ventures between tax-exempt hospitals and for-profit organizations have become a common mechanism for hospitals to acquire new sources of revenue and expand their health care services without completely relying on more traditional sources of funding.<sup>2</sup> The most common joint ventures are so-called ancillary joint ventures to create health care units such as endoscopy, magnetic resonance imaging centers, ambulatory surgical centers, physical therapy centers, hospital home care services, and nursing homes.<sup>3</sup> In hospital ancillary joint ventures, an exempt organization that

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\* J.D. Candidate, Spring 2008, Hastings College of the Law. Special thanks to Professor Robert L. Schwartz for his guidance and advice

1. Lauren W. Bright, *Tax-Exempt and Commercial Organization Joint Ventures*, ASSOCIATION MANAGEMENT, Dec. 2004, available at <http://www.asaecenter.org/PublicationsResources/-AMMagArticleDetail.cfm?ItemNumber=6382>.

2. Julius Green, *Joint Ventures with Tax-Exempt Hospitals*, PHYSICIAN'S NEWS DIGEST, Apr. 2006, available at <http://www.physiciansnews.com/business/406green.html>; JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 711 (3rd ed. 2006).

3. *Id.*; BARRY R. FURROW ET AL., THE LAW OF HEALTH CARE ORGANIZATION AND FINANCE, 588, (5th ed. 2004). "In 2004, research data on ancillary joint ventures conservatively estimates the number to be well over 1,000 including joint ventures with physician organizations. It is impossible to measure the effect the restrictive tax laws have had on whole hospital joint ventures, but scholars estimate that there are 50 to 100 whole hospital joint ventures currently in operation." Michael I. Sanders, *Symposium: Health Care and Tax Exemption: The Push and Pull of Tax Exemption Law on*

owns a hospital or health care facility contributes assets or funds to the establishment of the ancillary service, while continuing its other operations.<sup>4</sup>

Joint ventures between tax-exempt organizations and for-profit entities can lead to unfavorable tax consequences for the exempt organization if the venture is not structured in accordance with the rules and regulations provided by the Internal Revenue Service.<sup>5</sup> The ramifications include taxing the hospital's net income, eliminating the tax deductibility of future donations to the hospital, and, in many cases, revoking the hospital's exemption from state and local taxes, such as property and sales taxes.<sup>6</sup>

Before it issued Revenue Ruling 2004-51, the IRS had maintained that if a tax-exempt hospital entered into a joint venture with a for-profit organization and failed to exercise control over the venture, the revenue from the activity would be unrelated taxable income and the exempt organization's exempt status could be revoked.<sup>7</sup> The only available guidance regarding joint ventures concerned scenarios involving whole hospital joint ventures.<sup>8</sup> But in a whole hospital joint venture, the exempt organization contributes virtually all of its assets to the joint venture and the venture becomes the organization's principal operating purpose, whereas in an ancillary joint venture, the exempt organization continues to operate other charitable services.<sup>9</sup> The application of the available decisions and regulations to ancillary joint ventures remained uncertain.<sup>10</sup>

In addition to providing much-needed guidance regarding ancillary joint ventures, Revenue Ruling 2004-51 revoked the emphasis on the exempt organization's control of the joint venture, and held that an exempt organization would maintain its exempt status as long as it only contributed an insubstantial amount of its assets or activities to the venture.<sup>11</sup> However, the ruling failed to state the point at which the amount of an exempt organization's activities would no longer be considered insubstantial.

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*the Organization and Delivery of Health Care Services: Health Care Joint Ventures Between Tax-Exempt Organizations and For-Profit Entities*, 15 HEALTH MATRIX 83, 84 (2005).

4. Fishman & Schwarz, *supra* note 2, at 733 (quoting Mary Jo Salins, Judy Kindell & Marvin Frelander, *Whole Hospital Joint Ventures*, FY 1999 IRS Exempt Organizations Professional Education Technical Instruction Program 1 (1998)).

5. Bright, *supra* note 1. For the remainder of this note, the Internal Revenue Service will be referred to as the IRS or the Service.

6. Wayne Henry, *Tax-exempt challenges warrant hospitals' attention - includes related article on Healthcare Financial Management Association Task Force on Tax-Exempt Status*, HEALTHCARE FINANCIAL MANAGEMENT (Jan. 1991), available at [http://findarticles.com/p/articles/mi\\_m3257/is\\_n1\\_v45/ai\\_9312436](http://findarticles.com/p/articles/mi_m3257/is_n1_v45/ai_9312436).

7. Green, *supra* note 2.

8. *Id.*

9. See, e.g., Fishman & Schwarz, *supra* note 2, at 711.

10. *Id.*

11. Rev. Rul. 2004-51, 2004-22 I.R.B., 2004-1 C.B. 974 (2004).

Thus, tax-exempt hospitals contemplating embarking on an ancillary joint venture cannot always be sure their exempt status will remain unharmed.

This note examines the current uncertainty regarding the definition of a substantial amount of an organization's assets or activities and argues that participation in an ancillary joint venture should not be considered substantial unless it markedly restricts the furtherance of an exempt hospital's charitable purposes. Part II of this note provides an overview of the types of joint ventures involving tax-exempt hospitals and delineates the existing authority regarding joint ventures prior to Revenue Ruling 2004-51. Part III examines Revenue Ruling 2004-51 and highlight its shortcomings. Parts IV analyzes the insights provided by the substantial part test relating to lobbying activities conducted by exempt organizations, and an existing proposal to define substantiality regarding the unrelated business income tax (UBIT). Part V presents the implications and inadequacies of a recent private letter ruling on the quantification of substantial activity and Part VI proposes a new approach to analyzing substantiality.

## II. THE HISTORICAL BACKGROUND

Joint ventures involving tax-exempt hospitals are typically categorized as being either whole hospital or ancillary joint ventures.<sup>12</sup> The whole hospital joint venture emerged in the early 1990s due to the financial and other needs of the health care industry, and describes an arrangement in which the total assets and operations of a tax-exempt hospital are transferred to a joint venture entity, typically a limited liability company (LLC) in which both the hospital and for-profit participants are joint owners, and thereafter the hospital is operated as a for-profit entity.<sup>13</sup> An ancillary joint venture, in contrast, is an undertaking in which an exempt organization transfers less than the entirety of its operations to the venture.<sup>14</sup> In a typical ancillary joint venture, "a tax-exempt organization transfers a portion of its assets to and conducts a portion of its activities through a joint venture formed with a for-profit entity."<sup>15</sup> The tax-exempt organization uses its remaining assets to carry on its preexisting businesses.<sup>16</sup> Because much of the Service's guidance on joint ventures has

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12. Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 25 (2005).

13. *Id.*, at 25-26.

14. Gabriel O. Aitsebaomo, *Ancillary Joint Ventures and the Unanswered Questions After Revenue Ruling 2004-51* 23 (ExpressO Preprint Series Working Paper No. 394, 2004), available at <http://law.bepress.com/expresso/eps/394>.

15. *Id.* at 23-24.

16. *Id.* at 24.

focused primarily on whole hospital joint ventures, practitioners and scholars have wondered whether the Service would apply the same analysis in determining whether a tax-exempt hospital that enters into an ancillary joint venture with a for-profit entity would continue to maintain its tax-exempt status.<sup>17</sup>

#### A. A JOINT VENTURE'S IMPLICATIONS ON TAX-EXEMPT STATUS

An exempt organization's participation in a joint venture with a for-profit entity will not affect its tax exempt status provided the purpose of its involvement in the venture is in furtherance of its exempt purpose.<sup>18</sup> Section 501(c)(3) of the Internal Revenue Code requires that the exempt entity be organized and operated *exclusively* for exempt purposes, but the regulations interpret that standard as requiring that the exempt organization engage "primarily in activities that accomplish one or more . . . exempt purposes" and state that the exempt organization violates this standard if "more than an insubstantial" amount of its activities are not in furtherance of exempt purposes.<sup>19</sup> As the Supreme Court explained in *Better Business Bureau v. United States*, the presence of a single non-exempt purpose, if substantial in nature, will destroy the tax exemption regardless of the number of or importance of truly exempt purposes.<sup>20</sup> Accordingly, to maintain its tax-exempt status, a tax-exempt organization entering into a joint venture must establish that the venture will further its charitable purposes and is not organized or operated primarily for the benefit of private interests.<sup>21</sup> To predict whether their exempt status will remain protected, such organizations rely on published guidance.

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17. *Id.*

18. FURROW ET AL., *supra* note 3, at 573. Under section 501(c)(3) of the Internal Revenue Code, Corporations, and any community chest, fund, or foundation, *organized and operated exclusively* for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals [are exempt from taxation, so long as] no part of [their] net earnings . . . inures to the benefit of any private shareholder or individual, no substantial part of [their] activities . . . is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and [they do] not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3) (2004) (emphasis added).

19. *Id.*, citing 26 C.F.R. § 1.501(c)(3)-1(c)(1) (2004).

20. *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945).

21. Aitsebaomo, *supra* note 12, at 8.

## B. THE DARK AGES: PRE 2004-51

Before the issuance of Revenue Ruling 2004-51, the available guidance regarding joint ventures consisted of two cases and a revenue ruling, all of which involved whole hospital joint ventures.<sup>22</sup> The applicability of these decisions and rulings to ancillary joint ventures remained uncertain.<sup>23</sup>

Revenue Ruling 98-15 provides that a section 501(c)(3) organization may form and participate in a partnership and meet the operational test<sup>24</sup> if 1) participation in the partnership furthers a charitable purpose, and 2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.<sup>25</sup> But since Revenue Ruling 98-15 explicitly addresses whole hospital or whole entity joint ventures, it was unclear whether the revenue ruling and its control standard would apply to ancillary joint ventures.<sup>26</sup>

In *Redlands Surgical Services v. Commissioner*, a non-profit organization formed a partnership with a for-profit entity to operate a surgical center.<sup>27</sup> The tax court stated that the non-profit would not automatically lose its tax-exempt status because it had entered a partnership with a for-profit entity, but might not qualify for a tax exemption if it lacked control over the partnership.<sup>28</sup> When a tax-exempt organization cedes control over its sole activity to for-profit parties having an independent economic interest in the same activity and no obligation to put charitable purposes ahead of profit-making objectives, the organization cannot be assured that the joint venture will be operated in furtherance of charitable purposes.<sup>29</sup> In such a circumstance, courts will conclude that the exempt organization is not operated exclusively for charitable purposes.<sup>30</sup> Affirming the tax court, the Ninth Circuit held that ceding "effective control" of partnership activities impermissibly serves private rather than

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22. Green, *supra* note 2.

23. *Id.*

24. As discussed *supra* in note 16, section 501(c)(3) of the Internal Revenue Code stated that certain entities would be tax-exempt as long as they were operated in furtherance of specific exempt activities and did not engage in any impermissible activities.

25. Green, *supra* note 2.

26. *Id.*

27. *Redlands Surgical Servs., Inc. v. Comm'r*, 113 T.C. 47, 64 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001).

28. *See id.* at 75.

29. *Id.* at 78.

30. *Id.*

public interests.<sup>31</sup>

Similarly, *St. David's Health Care System v. United States* held that the determination of whether a non-profit organization that enters into a partnership operates exclusively for exempt purposes is not limited to whether the partnership provides charitable services.<sup>32</sup> This case concerned a whole hospital joint venture, where St. David's Health Care System, a tax-exempt entity operating an acute care hospital, entered into a limited partnership with a for-profit partner pursuant to which the partner would operate and manage the hospital.<sup>33</sup> The joint venture performed substantial charity care, but the IRS was concerned about whether St. David's retained enough control over the venture to ensure that charity care would continue into the future, without substantial private benefits flowing to the for-profit partner.<sup>34</sup> The court held that the non-profit partner must have the "capacity to ensure that the partnership's operations further charitable purposes" and that "the non-profit should lose its tax-exempt status if it cedes control to the for-profit entity."<sup>35</sup>

In 2004, after several court battles, a jury in the Fifth Circuit Court of Appeals ruled that St. David's Hospital had sufficient control over its joint venture to ensure that the venture was operating in a charitable manner.<sup>36</sup> The *St. David's* ruling established that control could be established in a whole hospital joint venture even when both parties held an equal fifty percent interest.<sup>37</sup> Though this was a favorable result, *St. David's* continued to leave unanswered the question of control in more common ancillary joint ventures.<sup>38</sup>

Unlike in a whole hospital joint venture, a tax-exempt organization participating in an ancillary joint venture continues to remain in existence and can still provide public benefit through several other charitable activities.<sup>39</sup> "[B]ecause an ancillary joint venture may involve the contribution of only an insignificant portion of the exempt organization's total assets, the organization's control over the joint venture is arguably less necessary to ensure that it is accomplishing its exempt purposes and meeting the operation test of section 501(c)(3)."<sup>40</sup> As Revenue Ruling 2004-51 makes clear, even where the control test is not satisfied, ancillary joint ventures will not endanger exempt status as long as the joint venture

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31. *Redlands Surgical Servs. v. Comm'r*, 242 F.3d 904, 904 (9th Cir. 2001).

32. *St. David's Health Care Sys. v. United States*, 349 F.3d 232, 236-237 (5th Cir. 2003).

33. FURROW ET AL., *supra* note 3, at 587-88.

34. *St. David's*, 349 F.3d at 232.

35. *Id.* at 239.

36. *Green, supra* note 2.

37. *Id.*

38. *Id.*

39. *Mirkay, supra* note 12, at 50.

40. *Id.*

activity is deemed insubstantial.<sup>41</sup>

### III. REVENUE RULING 2004-51

Shortly after the *St. David's* decision, the IRS responded with Revenue Ruling 2004-51. In the Ruling, the IRS held that an exempt organization that enters into an ancillary joint venture over which it does not have control would not affect its exempt status nor incur unrelated business income.<sup>42</sup>

The Ruling focused upon a tax-exempt university that provided summer training seminars to elementary and secondary schoolteachers as part of its educational program.<sup>43</sup> The university sought to expand the reach of its seminars by providing interactive video training to students at off-campus locations by forming a joint venture limited liability company with a for-profit video company.<sup>44</sup> Both the university and the video company held a fifty percent interest in the capital and profits of the LLC consistent with their respective contributions made to the venture.<sup>45</sup> The LLC agreement also provided that each party would appoint three board members with equal voting power.<sup>46</sup>

The LLC was responsible for conducting all aspects of the video teacher training seminars, including advertising, enrolling participants, arranging for the necessary facilities, distributing the course materials and broadcasting the seminars to various locations.<sup>47</sup> The courses would contain the same educational training content as provided by the university's campus programs.<sup>48</sup> The only difference would be that the teachers would participate through an interactive link at the off-campus site.<sup>49</sup> The university had the exclusive rights to approve the curriculum, training materials and instructors, and to determine standards for successful completion of the seminars, while the video company was given the responsibility of selecting the off-campus sites and approving of the technical components of the program.<sup>50</sup> The parties shared responsibility for all other aspects of the program equally.<sup>51</sup> The LLC agreement required

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41. FURROW ET AL., *supra* note 3, at 588.

42. Rev. Rul. 2004-51, 2004-1 C.B. 974 (2004).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*



that all contracts and transactions entered into by the LLC be at arm's length and at fair market value and forbade the LLC from acting in a manner that would jeopardize the university's exempt status.<sup>52</sup> Importantly, the fact pattern also explicitly stated that the exempt organization's participation in the LLC would be an "insubstantial part" of the exempt organization's activities within the meaning of section 501(c)(3) and section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.<sup>53</sup>

The Service restated the importance of control as a critical factor in meeting the operational test of section 501(c)(3), citing the applicable law under *Redlands* and *St. David's*, but never applied these cases in its analysis.<sup>54</sup> Instead, the Service simply concluded that because the activities that the tax-exempt university conducted through the joint venture were not a substantial part of the tax-exempt university's activities within the meaning of section 501(c)(3) and the relevant treasury regulations, the tax-exempt university's participation in the joint venture, taken alone, would not jeopardize its continued qualification for exemption.<sup>55</sup>

#### A. QUESTIONS LEFT UNANSWERED

Before Revenue Ruling 2004-51, a joint venture had to satisfy the two-prong test discussed in Revenue Ruling 98-15 for the tax-exempt organization to retain its tax-exempt status.<sup>56</sup> The IRS typically focused its inquiry on whether the joint venture's governing documents gave the tax-exempt organization voting control over the joint venture's management and activities.<sup>57</sup> "[S]uch control enables the tax-exempt organization to ensure that . . . the joint venture [is] used primarily to further its tax-exempt purposes and that the benefits to the private for-profit partners are only incidental to the accomplishment of such exempt purpose."<sup>58</sup> If the joint venture's governing documents did not expressly require the joint venture to prioritize the charitable purpose over profit maximization, the Service generally concluded that the tax-exempt participant would lose its tax exemption because organization was engaged in substantial activities that did not further its charitable purpose.<sup>59</sup>

In Revenue Ruling 2004-51, however, the Service dispensed with this

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52. *Id.*

53. *Id.*

54. *Id.*; Mirkay, *supra* note 12, at 58.

55. Rev. Rul. 2004-51, 2004-1 C.B. 974 (2004).

56. Rev. Rul. 98-15, 1998-1 C.B. 718 (1998).

57. Aitsebaomo, *supra* note 12, at 28.

58. *Id.* at 28-29.

59. *Id.* at 29.

analysis, stating factually and without further elaboration that the activities conducted by the tax-exempt organization through the joint venture were not a substantial part of the exempt organization's activities and were therefore disregarded in determining whether the exempt organization continued to qualify for tax exemption.<sup>60</sup> "The pertinent question, therefore, is how [one determines] when the assets and activities of an exempt organization that are transferred to an ancillary joint venture are an insubstantial part of the exempt organization's assets and activities."<sup>61</sup>

Regrettably, no further guidance appears in the ruling. One author has questioned whether the Service concluded the activities conducted through the joint venture were an insubstantial part of the tax-exempt organization's activities because the organization "transferred only 'a portion' of its assets to the joint venture and thus conducted only 'a portion' of its activities through the joint venture."<sup>62</sup> Assuming this theory is correct, such a conclusion calls into question precisely what amount of assets would qualify as an insubstantial part of the tax-exempt organization's assets or activities and preserve its exemption.<sup>63</sup>

Similarly, in using the phrase "taken alone" while concluding that the tax-exempt organization's participation in the joint venture described in the ruling would not affect its tax-exempt status, the Service suggests that insubstantial ancillary joint venture activities may in fact impair tax exemption if, in the aggregate, such activities comprise a substantial portion of the tax-exempt organization's activities.<sup>64</sup> The ruling implies that "when a tax-exempt organization is involved in multiple ancillary joint venture activities that are individually not considered substantial in comparison to the tax-exempt organization's overall activities, such multiple activities are aggregated" for purposes of determining substantiality.<sup>65</sup> This makes a bright-line percentage test all the more necessary.

## B. PREVAILING WISDOM

Many tax advisors believe that any amount up to five percent of gross revenues from an ancillary joint venture fits within a safe harbor and should not be treated as being substantial and that an amount between five

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60. *Id.* at 29-30.

61. *Id.* at 30.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

percent and fifteen percent is subject to a facts and circumstances test.<sup>66</sup> They also presume that in determining the percentage of revenues resulting from a joint venture, multiple ancillary activities would be aggregated to determine whether the activities comprise more than an insubstantial part of an organization's activities.<sup>67</sup>

A private letter ruling lends support to the advisors' belief.<sup>68</sup> An exempt organization wished to organize an LLC as an ancillary joint venture with for-profit lenders.<sup>69</sup> Under the proposed agreement, the exempt organization would contribute cash in return for an interest in the venture.<sup>70</sup> The cash contribution to the LLC represented *less than three percent* of the exempt organization's available consolidated assets.<sup>71</sup> Aside from the fact that the venture furthered the exempt organization's charitable purpose, the Service ruled that the organization's contributions to the LLC represented a relatively small portion of the exempt organization's assets and would not impair its ability to continue to conduct its other charitable activities.<sup>72</sup>

While this ruling seems to provide definitive proof that a contribution of three percent or less of an exempt organization's assets to an ancillary joint venture will be deemed insubstantial, it did not suggest what other percentages would similarly be considered a relatively small or insubstantial portion of an exempt organization's assets. However, based on the Service's rationale, a good argument can be made that so long as the exempt organization's contribution does not impair its ability to conduct its exempt activities, the contribution should be considered insubstantial. The relevant question then becomes how to measure whether a contribution will impair the exempt organization's ability to execute its charitable purpose.

#### IV. THE SUBSTANTIAL PART TEST AND THE LESSONS FROM UBIT

##### A. LOBBYING ACTIVITIES AND THE SUBSTANTIAL PART TEST

In addition to defining the types of entities that would be exempt from taxation, section 501(c)(3) on the Internal Revenue Code provided a clear limitation that no substantial part of an organization's activities could

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66. Reed Smith, Client Memo: IRS Publishes Ancillary Joint Venture Revenue Ruling, June 11, 2004, available at [http://www.reedsmith.com/\\_db/\\_documents/hc0411.pdf](http://www.reedsmith.com/_db/_documents/hc0411.pdf).

67. *Id.*

68. I.R.S. Priv. Ltr. Rul. 200351033 (Sept. 26, 2003).

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

include carrying on propaganda or otherwise attempting to influence legislation.<sup>73</sup> An organization that devotes a substantial part of its activities to influencing legislation will be found to be an action organization disqualified from tax-exempt status.<sup>74</sup> While there is no statutory or regulatory definition of the amount of legislative activity that would constitute a “substantial part” of an organization’s activities, case law provides limited guidance.

In *Seasongood v. Commissioner*, the court held that devoting less than five percent of activities to lobbying is not substantial.<sup>75</sup> Taxpayers had contributed money to a good government league and sought to claim their contributions as deductions on their income tax returns.<sup>76</sup> The Internal Revenue Code allowed deductions for individual contributions and gifts to corporations operated exclusively for religious, charitable, scientific, literary, or educational purposes.<sup>77</sup> The term “exclusively,” as used in this section, did not have its ordinary meaning, and activities that were minor and insubstantial would not disqualify charitable or educational corporations from the benefits of the exemption or disqualify individual contributors to such corporations from deducting their contributions.<sup>78</sup> The court reasoned that organizations formed for purely charitable purposes might, in the course of their existence, as an instance of their activities, be forced to take part in some political activity.<sup>79</sup> Only when such activities constitute a substantial part of their general activity would relief be denied.<sup>80</sup> While the league’s activities were essentially educational, even if some were condemned as propaganda or attempts to influence legislation, they were not substantial since they engaged less than one-twentieth (or five percent) of the time and effort that the league put forth in the public interest.<sup>81</sup> Thus, the league’s so-called “political activities” were not substantial in relation to its other activities.<sup>82</sup>

In contrast, the court in *Haswell v. United States* held that spending over sixteen percent of an organization’s time on lobbying was substantial.<sup>83</sup> The court found that applying a strict percentage test to determine whether activities are substantial would be inappropriate, since

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73. I.R.C. § 501(c)(3) (2004).

74. 26 C.F.R. § 1.501(c)(3)-1(c)(3)(ii) (2004). See Joanna Pressman, *Legislative and Political Campaign Activity Limitations Under Internal Revenue Code Section 501(c)(3)*, available at [http://www.stblaw.com/content/Publications/Publication24\\_0.pdf](http://www.stblaw.com/content/Publications/Publication24_0.pdf).

75. Pressman, *supra* note 73; *Seasongood v. Comm’r*, 227 F.2d 907, 912 (6th Cir. 1955).

76. *Seasongood*, 227 F.2d at 908.

77. *Id.* at 909.

78. *Id.* at 910.

79. *Id.* at 909.

80. *Id.*

81. *Id.* at 912.

82. *Id.*

83. *Haswell v. United States*, 205 Ct. Cl. 421, 444 (Ct. Cl. 1974).

such a test "obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances in the context of the totality of the organization."<sup>84</sup> However, the organization in this case was relatively small and had used over sixteen percent of its expenditures on political activities in 1968 and considerably more during previous years.<sup>85</sup> These percentage relationships indicated the relative importance of legislative activities in the organization's total effort.<sup>86</sup> Because the organization operated on a small budget and devoted so much of its total resources to legislative activities, the court concluded that its purposes did not accord with the conceptions traditionally associated with a common-law charity.<sup>87</sup>

These cases reinforce the notion that a contribution from an exempt organization to an ancillary joint venture that interferes with the organization's ability to effectuate its exempt purpose can jeopardize the organization's exempt status. While the decision in *Seasongood* indicates that a contribution of five percent or less of an exempt organization's assets and activities may automatically qualify as insubstantial and avoid risking the organization's exempt status, it is not clear whether a contribution comprising over sixteen percent of the organization's resources will result in the revocation of tax exemption. The organization in *Haswell* operated on a limited budget, but a larger, wealthier organization might have been able to make a proportionate contribution to a joint venture without hampering its charitable operations. Further, since a strict percentage test can obscure other relevant factors regarding an exempt organization's ability to further its exempt purpose, consideration of the time and resources the organization devotes to its exempt purpose may be more pertinent to the tax exemption analysis.

## B. UBIT AND SANDERS' PROPOSAL

The unrelated business income tax (UBIT) is specifically imposed on income from a trade or business activity that is not substantially related to the exempt organization's exercise or performance of its exempt purpose or function.<sup>88</sup> "[A]n exempt organization may engage in trade or business

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84. *Id.* at 436. See also *Christian Echoes Nat'l Ministry v. United States*, 470 F.2d 849, 855 (10th Cir. 1972).

85. *Haswell*, 205 Ct. Cl. at 443.

86. *Id.* at 443-44.

87. *Id.* at 444.

88. *Mirkay*, *supra* note 12, at 32.

To be considered "related" to an organization's exempt purposes or function, the conduct of the business activities must have a causal relationship to the achievement of exempt purposes other than through the production of income. A

activities that are unrelated to its exempt purposes provided the activities are only incidental to, or less than a substantial part of, its exempt purpose activities.”<sup>89</sup>

If a substantial portion of an organization’s income derives from unrelated activities, that organization will most likely fail to qualify for tax exemption.<sup>90</sup> “For example, the IRS has held that an organization’s exemption may be denied or revoked if it earns greater than fifty percent of its annual receipts from unrelated business activities.”<sup>91</sup> “[T]he common measure of substantiality or lack thereof has been in terms of percentage of time or expenditures.”<sup>92</sup> However, neither the IRS nor the courts have consistently applied any particular standard in determining whether an organization’s unrelated business activities are substantial.<sup>93</sup>

The IRS has periodically applied a “commensurate in scope” test, first articulated in Revenue Ruling 64-182, which compares an exempt organization’s financial resources to its exempt activities or efforts.<sup>94</sup> “Under this test, a substantial portion of an exempt organization’s total revenues may flow from unrelated business activities, but not affect its tax-exempt status if a *significant amount* of the organization’s time and efforts are spent on its exempt functions or activities.”<sup>95</sup>

In Revenue Ruling 64-182,

[A]n organization owned and operated a commercial office building, the rental income from which comprised the entirety of the organization’s income. Although the income was from an unrelated business activity, the IRS concluded that the organization was exempt under section 501(c)(3) because its primary exempt function or activity of making grants to other exempt, charitable organizations was “commensurate in scope with its financial resources.”<sup>96</sup>

“[I]n subsequent technical advice, the IRS concluded that an organization organized and operated for charitable purposes that earned ninety-eight percent of its income from unrelated business activities was still exempt under section 501(c)(3) because the organization expended more than forty

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causal relationship is “substantial” if “the production or distribution of the goods or the performance of the services from which the gross income is derived . . . contributes importantly to the accomplishment of those exempt purposes.”

*Id.* (quoting Treas. Reg. 1.513-1(d)(3) (1983)).

89. *Id.*

90. *Id.* at 33.

91. *Id.*, citing I.R.S. Gen. Couns. Mem. 39,108 (Dec. 23, 1982), available at 1983 IRS GCM LEXIS 147.

92. Mirkay, *supra* note 12, at 33.

93. *Id.* at 33-34.

94. *Id.* at 34.

95. *Id.* (emphasis added).

96. *Id.* n98 (citing Rev. Rul. 64-182, 1964-1 C.B. 186 (1964)).

percent of its time on exempt programs or activities.”<sup>97</sup> One might therefore conclude that so long as an exempt organization can continue to devote at least forty percent of its resources to the furtherance of its charitable purpose, it should continue to qualify for tax exemption.

Michael I. Sanders, a noted practitioner in the area of exempt organizations law, has proposed the adoption of a numerical test to distinguish ancillary joint ventures from whole hospital joint ventures.<sup>98</sup> “Sanders proposes that ten to fifteen percent of an exempt organization’s total assets could be used in ancillary joint ventures without a negative impact on the organization’s tax-exempt status,” and contemplates an aggregation limitation “to prevent abuse of such a standard by engaging in a number of ancillary joint ventures that each fit within [this] safe harbor.”<sup>99</sup> Indeed, multiple individual ancillary transactions might collectively comprise more than an insubstantial amount of an exempt organization’s assets or resources, so the entirety of the organization’s ancillary activities could no longer be considered ancillary.<sup>100</sup>

Sanders’ suggestion of a percentage test combined with an aggregation limitation provides a clear standard for exempt organizations and tax advisers to apply when analyzing a joint venture’s potential tax consequences.<sup>101</sup> However, it is unclear whether Sanders’ proposed percentage test and safe harbors would be appropriate for all joint ventures. Depending on the totality of an organization’s assets, the devotion of ten to fifteen percent of its assets to a joint venture might interfere with the organization’s ability to further its charitable activities. Moreover, the fact that the IRS and reviewing courts have failed to adopt and apply a clear standard differentiating between insubstantial versus substantial unrelated business activities when analyzing the applicability of the UBIT to exempt organizations suggests that a bright-line test or safe harbor for participation in ancillary joint ventures, like the test found in Sanders’ proposal, will not appear in the near future.<sup>102</sup> This unlikelihood of further guidance was made clear in a recent private letter ruling.

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97. *Id.* at 34 (citing I.R.S. Tech. Adv. Mem. 97-11-003 (Nov. 8, 1995)).

The organization [in this memorandum spent more] than forty percent of its time and resources to the assistance of developmentally disabled children over the past thirty years, and the IRS concluded that the commensurate-in-scope test was not applicable because the organization had a “substantial charitable program in addition to its fundraising activities.”

*Id.* n101. Question whether the IRS referred to the percentage of revenue spent on this activity, or the charity’s duration in remarking on the organization’s “substantial charitable program.”

98. *Id.* at 66.

99. *Id.* at 66-67.

100. *Id.* at 67.

101. *Id.*

102. *Id.*

#### V. PRIVATE LETTER RULING 200610022 – THE LATEST FAILED ATTEMPT TO PROVIDE DIRECTION

This ruling concerned a tax-exempt non-profit educational and literary organization whose principal aim was to honor, preserve, study and disseminate scholarship about the life and works of a particular author.<sup>103</sup> In the past, the literary organization had conducted all of the operations in writing, publishing, and distributing its educational journal.<sup>104</sup> In order to more efficiently accomplish the publication and distribution of the journal, the organization proposed to enter into an agreement to sell a one-half interest in the journal to a for-profit corporation that would be in charge of publication.<sup>105</sup> The sale and joint publication agreement was similar to a joint venture between the literary organization and the publisher.<sup>106</sup> The exempt entity would be responsible for virtually all of the editorial functions of the journal and the for-profit publisher would be responsible for all of the printing and dissemination costs.<sup>107</sup> The publisher would pay royalties to the literary organization on revenues from institutional subscriptions, non-subscription revenue earned, and on all advertising in the journal.<sup>108</sup> The organization contemplated that it would conduct significant activities involved in generating advertising revenues, although such revenues were contemplated to be *de minimis*.<sup>109</sup>

In determining whether the exempt organization continued to qualify for exemption from federal income tax the Service referred to Revenue Ruling 2004-51, which had previously approved a joint venture where a large university provided educational material to a for-profit partner that disseminated the material through interactive video technology.<sup>110</sup> In that case there was an additional fact that the partnership activity constituted only an “insubstantial part” of the exempt activities of the university.<sup>111</sup> Here, by contrast, the publishing of the literary journal and the other activities under the agreement constituted a substantial part of the literary organization’s activities, so the Service concluded that Revenue Ruling

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103. I.R.S. Priv. Ltr. Rul. 200610022 (Dec. 12, 2005).

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*



2004-51 was not applicable to this scenario.<sup>112</sup>

The Service then looked at whether the joint venture satisfied the two-part test of Revenue Ruling 98-15 and ultimately concluded that the organization's sale of the half interest in the joint venture to the for-profit publisher would not affect its exempt status.<sup>113</sup> The literary organization retained full control over the editorial content of the publications and the agreement permitted the organization to act exclusively in furtherance of its exempt purpose by creating the editorial content of the journal and the other publication.<sup>114</sup> The benefit enjoyed by the for-profit publisher did not create a disqualifying impermissible purpose since the publisher's benefit was only incidental to this exempt purpose, giving it a negotiated share of the revenues as fair market compensation for the printing, publishing and dissemination services that it provided.<sup>115</sup> Given the esoteric nature of the journal content, the limited demand for such material, and the negotiation for a fair market value agreement, the Service concluded that the publisher would not obtain substantial monetary benefits.<sup>116</sup>

#### A. WHAT DOES IT ALL MEAN?

Regrettably, the Service chose to factually state that the organization would devote a substantial amount of activities to the joint venture, rather than parse through an analysis of why the activities were substantial. As it had previously done in Revenue Ruling 2004-51, the Service relied on the factual assertion to immediately reach a conclusion without further discussion. However, this ruling still confirms that whether an exempt organization's participation in an ancillary joint venture will be considered substantial depends on the time and resources allocated to the joint venture.

In this ruling, the organization granted the publisher a one-half interest to shoulder the burden of publication. While it remains ambiguous how much time and effort the exempt organization was devoting to the securing of revenues and royalties, and how much was spent on creating the publication, the Service considered the substantiality of its activities based collectively on the composition of the publications and any other activities. It is clear that the vast majority of the organization's time and effort would be spent creating the scholarly publication and very little was left for independent activities.

Additionally, this ruling confirms that the extent of the exempt

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112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

organization's participation in an ancillary joint venture is more important than retention of control over the venture, since the Service considered whether the literary organization satisfied Revenue Ruling 2004-51 before proceeding to the two prong test of Revenue Ruling 98-15. Thus, control over an ancillary venture operates as a failsafe for an exempt organization to maintain its exempt status, if the amount of its activities contributed to the venture is deemed substantial.

## VI. A NEW APPROACH

Since the IRS has not been forthcoming about the amounts of an exempt organization's assets or activities that will be considered substantial, exempt organizations looking to participate in ancillary joint ventures with for-profit partners should focus on ensuring that they will be able to avoid a significant decline in their independent charitable activity. While the provision of a safe harbor percentage might be useful, such percentages might not be generally applicable to every joint venture. Currently, the contribution of five percent or less of the exempt organization's assets and activities to the joint venture will almost certainly be deemed insubstantial, but anything beyond that will require analyzing the organization's total assets and capacity to further its exempt activities.

Instead of creating a more extensive safe harbor provision, the Service should establish guidelines regarding when an exempt organization might not realistically be able to fully conduct its exempt activities. An expansion of the commensurate in scope test applied in UBIT considerations would be appropriate. Where an exempt organization expends at least half of its resources in furtherance of its exempt purpose, it should ordinarily be allowed to preserve its tax-exempt status, since the prohibitions on impermissible private benefits or activities provide insurance that the venture will not stray too far from the charitable activity. Even where the exempt organization does not control the venture, if its charitable services remain significant and it continues to satisfy section 501(c)(3) of the Internal Revenue Code, it should be allowed to enjoy its tax exemption.

In the context of a non-profit hospital, for instance, expending just forty percent of its resources to provide charitable health care services would still enable it to provide a significant amount of public benefit. Since many ancillary joint ventures have the goal of creating health care units and increasing the quality of the care the hospital can provide, ceding control over an ancillary joint venture to the for-profit partner should not affect the hospital's tax-exempt status, particularly if the for-profit partner would hardly realize any profits from the venture. As long as the hospital

satisfies the operational test of section 501(c)(3), the public services it is providing should outweigh any implication that it might abuse its exempt status when embarking on an ancillary venture. If the Service provided a standard for determining when participation in an ancillary joint venture would outweigh an exempt organization's independent charitable services, the current uncertainty regarding the threshold of substantiality would be lifted.

## VII. CONCLUSION

Until the IRS clarifies its definition of substantial activity regarding ancillary joint ventures, any tax-exempt hospital considering participating in a joint venture with for-profit entities or individuals should determine whether the nature and extent of the hospital's control over the activities of the joint venture will support the conclusion that the activity of the joint venture is related to its exempt purposes. If the control is insufficient, the hospital should consider whether its activity in the venture is substantial relative to its exempt activities. While a contribution of less than five percent of the hospital's assets and resources will ensure the preservation of its tax exemption, as long as the ancillary activities do not impair the hospital's charitable functions or create impermissible private benefits, the hospital's tax-exempt status should remain secure.

The aggregation of ancillary activities and the point at which such activities would no longer be deemed ancillary still remains in question. It would be immensely helpful if the Service issued a ruling involving a tax-exempt hospital participating in various ancillary ventures and discussed the precise moment when the ancillary activities became substantial. Such a ruling could potentially provide an absolute definition to substantial activity, thereby making any new proposals unnecessary. In the meantime, hopefully this note has provided some useful insights.